The Pre-filing Agreement Pilot Project Was Successful, But Faces Challenges in Converting to an Operational Program

August 2001

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 14, 2001

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION

Pamela J Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Pre-filing Agreement Pilot Project Was Successful, But Faces Challenges in Converting to an Operational Program

This report presents the results of our review of the Internal Revenue Service's (IRS) Large and Mid-Size Business (LMSB) Division's Pre-filing Agreement Pilot Project. Our objective was to determine whether it was effectively designed and implemented to provide officials with reliable information for deciding whether it should be expanded, modified, or terminated. In summary, the Pre-filing Agreement Pilot Project was effectively designed and executed to provide officials with reliable information. Because the pilot project was effectively designed and executed, the IRS was able to successfully validate the concept of a Pre-filing Agreement. However, significant challenges remain in successfully converting the pilot project into an operational program over the next several years.

The Commissioner, LMSB Division, agreed to implement the recommendation on developing a Management Information System, but did not agree with the other four recommendations. We recognize most challenges can be managed through existing processes, now that the Division is expecting a significant decline in the demand for pre-filing agreements compared to the number it estimated at the time of our review. We believe that this decline in the number of agreements coupled with the decision not to take actions on our recommendations will, in the long term, adversely affect the Pre-filing Agreement Program. However, we do not intend to elevate the disagreements to the Treasury Department for resolution, and no further action on your part is required. Comments on our recommendations and our evaluation of the response can be found beginning on page 10 of the report. Appendix IV contains a complete response to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Executive Summary

The Internal Revenue Service's (IRS) Large and Mid-Size Business (LMSB) Division serves approximately 224,000 business taxpayers with over $5 million in assets. These taxpayers make annual cash payments of approximately $712 billion. The LMSB Division annually examines 20,000 returns, including 450 to 575 of the nation's largest corporations. Part of the Division's mission is to be a world class organization, responsive to the needs of business taxpayers in a global environment, while applying innovative approaches to customer service and compliance.

One of the LMSB Division's four strategic initiatives to meet its mission is to implement a comprehensive issue management strategy that emphasizes pre-filing efforts to improve examination currency and resolve high-risk issues earlier in the process. The Pre-filing Agreement Pilot Project is the first of several initiatives underway to implement a new method of operation by applying expert resources to the needs of sophisticated taxpayers in a cooperative environment.

The purpose of the Pre-filing Agreement Initiative is to provide the LMSB Division's taxpayers a process to request examination and resolution of specific issues relating to tax returns not yet filed. Through the cooperative efforts of taxpayers and the IRS, the process is designed to reduce the costs, burden, and delays encountered in post-filing examinations.

The objective of this review was to determine whether the Pre-filing Agreement Pilot Project was effectively designed and implemented to provide officials with reliable information for deciding whether it should be expanded, modified, or terminated.

Results

The Pre-filing Agreement Pilot Project was effectively designed and executed to provide officials with reliable information. The LMSB Division received 19 applications to participate in the pilot project, and approved 12 of them from 11 different taxpayers. During the pilot's initial 6-month time frame, the LMSB Division completed Pre-filing Agreements for 7 of the 12 applications accepted. Because the pilot project was effectively designed and executed, the IRS was able to successfully validate the concept of a Pre-filing Agreement. However, significant challenges remain in successfully converting the pilot project into an operational program over the next several years.

The Pre-filing Agreement Pilot Project's Objectives Were Accomplished

The results of the Pre-filing Agreement Pilot Project revealed that agreements could be resolved in a cooperative environment within the required time frame, accomplishing the objectives of the pilot program. The pilot was designed and implemented effectively in accordance with objectives, guidelines and procedures outlined in the IRS' report "Pre-filing Agreement Process Pilot Program Orientation," issued in April 2000, and Notice 2000-12, "Pre-Filing Agreement Pilot Program." Feedback during the project indicated that taxpayers would be willing to participate in the process again, and that it could be an effective tool in the large corporate examination program, saving significant time and money for both taxpayers and the IRS. As a result, LMSB Division management decided to proceed with full program implementation.[1]

Significant Challenges Remain in Converting the Pre-filing Agreement Pilot Project into an Operational Program

Several significant operational challenges remain in converting the Pre-filing Agreement Pilot Project into an effective and efficient operational program. To successfully pilot Pre-filing Agreements many of the obstacles associated with an operational program were eliminated or not present. Specifically:

- The pilot cases were given priority access to scarce examination specialist resources. When the Pre-filing Program is operational this priority access may not be available to all pre-filing cases.
- Agreements were limited to one tax issue for one tax year, but taxpayers involved in the test recommended that agreements in an operational program cover more than one year.
- The 11 taxpayers involved were part of the 1,700 taxpayers in the Coordinated Examination Program (CEP) that have an ongoing examination relationship with the IRS. In most cases the examination team conducting the Pre-filing Agreement examination was familiar with the issue and the taxpayer's books and records. However, the same level of familiarity is not likely to be present when the program is expanded to include all 224,000 LMSB Division taxpayers.
- The cases were closely monitored and scrutinized by various levels of the LMSB Division management team, which eliminated the need for a systematic quality review system. Such a quality review system would, however, be needed in an operational program.

[1] Rev. Proc. 2001-22, I.R.B. 9.

- An informal, flexible and effective management information system (MIS) evolved to allow managers to direct and capture project accomplishments. However, this system may not be functional with hundreds of cases.

The LMSB Division management team is taking action to address many of these challenges and is in the process of converting the pilot project to an operational program. Successful transition from the pilot phase to an operational program holds promise for improving taxpayer satisfaction, facilitating voluntary compliance, and reducing post-filing examination cycle time. It could also reduce costs and burdens to both the taxpayer and the IRS.

Summary of Recommendations

The Director, Strategy, Research and Program Planning, and Director of Field Specialists should establish criteria to allocate examination specialists resources to returns with the most significant issues in pre-filing and post-filing activities. The Commissioner, LMSB Division, should also expand Pre-filing Agreements to cover multiple years. The Director of Pre-filing and Technical Guidance should study taxpayers without an ongoing examination relationship to determine if the program needs to be adjusted to meet the needs of this specific group. The Director, Performance, Quality and Innovation should establish a method of systematic quality control for pre-filing to maintain consistent case development standards. Finally, the Director, Business Systems Planning needs to have an MIS developed to support the Pre-filing Program that integrates with other LMSB Division information systems.

Management's Response: The Commissioner, LMSB Division, agreed to implement the recommendation on establishing an MIS for the Pre-filing Agreement Program. However, the Commissioner did not agree to: (1) establish criteria for allocating resources between pre-filing and post-filing activities, (2) expand pre-filing agreements to cover multiple years, (3) adjust the pre-filing program to meet the needs of all LMSB taxpayers, and (4) develop a quality control system for pre-filing agreements.

Office of Audit Comment: The LMSB Division is now expecting a significant decline in the demand for pre-filing agreements compared to what it estimated at the time of our review. Consequently, we recognize that establishing criteria for allocating resources between pre-filing and post-filing activities, adjusting the pre-filing program to meet the needs of all LMSB Division taxpayers, and developing a quality control system for pre-filing agreements can be achieved through existing processes. However, we believe the expected decline in the number of agreements coupled with the decision not to take actions on our recommendations will, in the long term, adversely affect the Pre-filing Agreement Program.

The fact that multiple-year agreements are not offered could be a contributing factor to a lower than projected interest in the program. In deciding no action was necessary to expand pre-filing agreements over multiple years, the Commissioner, LMSB Division, stated that multiple-year agreements are outside the Division's current authority. We agree with the technical accuracy of the Commissioner's comment. However, we believe that the Commissioner, LMSB Division, could initiate actions to request the delegated authority from the IRS Commissioner. Implementing multiple- year agreements would be responsive to the taxpayers' stated needs and would demonstrate a change to a more customer-focused IRS organization.

Objective and Scope

We evaluated whether the Pre-filing Agreement Pilot Project was effectively designed and implemented to provide officials with reliable information for deciding whether it should be expanded, modified, or terminated.

Our objective was to determine whether the Large and Mid-Size Business (LMSB) Division's Pre-filing Agreement Pilot Project was effectively designed and implemented to provide officials with reliable information for deciding whether it should be expanded, modified, or terminated. The audit tests were focused in the following areas:

- Evaluated the process developed and followed for implementing the Pre-filing Agreement Pilot Project by reviewing the planning documents, training materials, and application packages.
- Analyzed the process used to measure results of the pilot by evaluating monthly monitoring reports and surveys of the participating Internal Revenue Service (IRS) employees and taxpayer applicants.
- Reviewed the supporting administrative files of five accepted Pre-filing agreement applications to examine issue development and capture starting date, completion date, and staff days expended in the process by the examination team.

We performed the audit in accordance with *Government Auditing Standards* between November 2000 and March 2001. On-site tests were performed in the LMSB Division's National Headquarters and at IRS offices in Fayetteville, Arkansas; Independence, Ohio; Redwood City, California; and San Francisco, California.

Details of our objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The LMSB Division serves approximately 224,000 business taxpayers with over $5 million in assets. These taxpayers make annual cash payments of approximately $712 billion. The Division annually examines 20,000 tax returns, including 450 to 575 of the nation's largest corporations. Part of the LMSB Division's mission is to be a world class organization, responsive to the needs of business taxpayers in a global environment, while applying innovative approaches to customer service and compliance.

The Pre-filing Agreement Pilot Project is the first of several initiatives to demonstrate a new method of operation by applying expert resources to sophisticated taxpayer needs in a cooperative environment.

One of the LMSB Division's four strategic initiatives to meet its mission is to implement a comprehensive issue management strategy that emphasizes pre-filing efforts to improve examination currency and resolve high-risk issues earlier in the process. The Pre-filing Agreement Pilot Project is the first of several initiatives underway to implement a new method of operation by applying expert resources to the needs of sophisticated taxpayers in a cooperative environment.

A Pre-filing Agreement is a "closing agreement" under provisions of Internal Revenue Code (I.R.C.) section 7121.[1] A closing agreement is a contractual arrangement between a taxpayer and the IRS that is final and conclusive with respect to a specific tax issue raised under the internal revenue law for a specified tax period.

The purpose of the Pre-filing Agreement Initiative is to provide the LMSB Division's taxpayers with a process to request examination and resolution of specific issues relating to tax returns not yet filed. Through the cooperative efforts of taxpayers and the IRS, the process is designed to reduce the costs, burden and delays encountered in post-filing examinations.

[1] I.R.C. Section 7121(a) and (b) (1986).

Results

Seven Pre-filing Agreements were successfully completed in the 6-month time frame, but significant challenges remain.

The Pre-filing Agreement Pilot Project was effectively designed and executed to provide officials with reliable information. The LMSB Division completed 7 pre-filing agreements during its initial 6-month time frame, from a total of 12 applications accepted[2] from 11 corporate taxpayer volunteers. Because the pilot project was effectively designed and executed, the IRS was able to successfully validate the concept of a Pre-filing Agreement. However, significant challenges remain in successfully converting the pilot project into an operational program over the next several years.

The Pre-filing Agreement Pilot Project's Objectives Were Accomplished

The results of the Pre-filing Agreement Pilot Project revealed that agreements could be resolved in a cooperative environment within the required time frame, accomplishing the objectives of the pilot program. This led to the decision by the LMSB Division management to proceed with full program implementation.[3]

The pilot was designed and implemented effectively in accordance with objectives, guidelines and procedures outlined in the IRS' plans.

The pilot was designed and implemented effectively in accordance with objectives, guidelines and procedures outlined in the IRS' report "Pre-filing Agreement Process Pilot Program Orientation" issued in April 2000, and Notice 2000-12, "Pre-Filing Agreements Pilot Program." The expectations or objectives of the Pre-filing Agreement Pilot Project outlined in the orientation report were to:

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[2] There were 19 applications to participate in the pilot project, from which the LMSB Division accepted 12.

[3] Rev. Proc. 2001-22 I.R.B. 9.

The primary objective of the pilot was to determine whether the Pre-filing Agreement process was workable and would produce the desired results.

1. Determine whether the Pre-filing Agreement process was workable and produced desired results.
2. Determine whether or not to proceed with full implementation.
3. Identify design shortcomings, and revise and finalize procedures before full implementation.
4. Identify training and communication needs for internal and external stakeholders.
5. Test process specific tools.

The orientation report also describes the history behind the Pre-filing Agreement Pilot, the mechanics of the process, the roles and responsibilities of the participants, and the monitoring and evaluation of the pilot.

Notice 2000-12 described the program to the public. The notice indicates that the program is restricted to taxpayers under the jurisdiction of the LMSB Division. It describes to the public the transactions that will not be considered for a Pre-filing Agreement and how to prepare an application. The notice also described the selection criteria the LMSB Division will use in evaluating the applications. Lastly, the notice describes the potential outcomes from obtaining a Pre-filing Agreement and options when an agreement cannot be obtained prior to filing the return.

The pilot project was executed in accordance with the IRS' plans.

The pilot was executed in accordance to the plan described in the orientation report and Notice 2000-12. Our review of the 19 application packages found no deviations from the selection criteria described in Notice 2000-12. The pre-filing examinations reviewed during the audit met the appropriate auditing standards for issue development and tax law application in the three cases where issue development was completed. The information reviewed in time monitoring reports and field team's work was found to be materially correct in all cases reviewed.

Feedback captured during the project found that taxpayers that completed agreements would be willing to participate in the process again. Representatives of the six taxpayers that executed the seven agreements with the IRS all indicated in a post-pilot survey that they would be willing to participate again.

Feedback also shows that it could be an effective tool in the large corporate examination program, saving significant time and money for both taxpayers and the IRS. For example, from the pilot's evaluative and monitoring reports of the 7 accepted applications involving 6 taxpayers with a pre-filing agreement, taxpayers saved 2,265 hours, $637,750 in costs and 1,952 days in process, while the IRS saved 5,368 hours, $287,728 in costs and 2,166 days in process.

The IRS is offering the Pre-filing Agreement Program on a permanent basis.

Due to the positive results and feedback, the IRS has offered the program on a permanent basis with the release of Revenue Procedure 2001-22 on January 22, 2001.

Significant Challenges Remain in Converting the Pre-filing Agreement Pilot Project into an Operational Program

Obstacles associated with an operational program were eliminated or not present during the successful Pre-filing Agreement Pilot Project.

Several significant operational challenges remain in converting the Pre-filing Agreement Pilot Project into an effective and efficient operational program. To successfully pilot Pre-filing Agreements many of the obstacles associated with an operational program were eliminated or not present.

The Pre-filing Agreement Pilot Project proved that the IRS and large corporate taxpayers could work cooperatively to resolve potentially contentious tax issues. However, a permanent operational program requires that business risks that may affect achieving program objectives be identified and that control activities be designed into the work processes. Well designed control activities ensure operational efficiency and effectiveness. Without effective controls, the IRS risks wasting program dollars and losing public confidence.

Pilot cases were given priority access to scarce examination specialist resources

In the Pre-filing Pilot Project, 9 (82 percent) of the 11 taxpayers required the assistance of one or more specialists. The 9 returns to be filed required 2,704 hours of direct examination time (DET), or about one and one-third staff years of specialists' time. This is an average of approximately 246 hours of specialist DET per return to be filed. For comparison, in Fiscal Year (FY) 2000, examinations of post-filed returns averaged 241 hours of specialist DET[4] per return. We are concerned that when the Pre-filing Initiative becomes fully operational, this same level of priority access may not be possible, potentially hindering the program's ability to meet its goals and milestones.

The post-filing examination program may lose as much as 10 staff years of specialists' time in FY 2001 if resources are allocated on the same basis as in the Pre-filing Agreement Pilot Project.

At the time of our audit, the LMSB Division planned to accept 100 cases into the Pre-filing Program in FY 2001. Based on the use of specialists in the Pre-filing Pilot Project, approximately 82 of these cases would need specialist resources. If the Pre-filing Program receives the same specialty resource priority as the pilot project and uses resources per case at the same level, then approximately 10 staff years of specialists' time would be used by Pre-filing Agreements and would be unavailable for post-filing examinations.

Further, there is a greater time sensitivity in Pre-filing Agreements, since the agreements must be started six months prior to the tax return filing date. According to a management report, the Pre-filing Agreement process should be completed two months prior to the filing date. This leaves only four months to develop a complex tax issue and places a significant burden on the employees to complete a Pre-filing Agreement.

A pre-filing examination is limited to a single tax year return, whereas a post-filing examination usually

[4] Specialist DET of 436,417 hours applied to 1,808 Coordinated Examination Program (CEP) post-filing return examinations equals 241 specialist hours per return.

includes the examination of multiple tax years, allowing tax issue development time to be spread over more returns. Further, while not all post-filing Coordinated Examination Program (CEP) return examinations used specialists, our analysis of the Coordinated Examination Management Information System (CEMIS) showed that 1,079 (89 percent) of the 1,212 primary CEP returns closed in FY 2000 did use a specialist. Due to the inherent limitations in the information systems it is not possible to determine the number of hours applied to a specific tax issue.

Several specialist team members in the pilot project advised us that they would probably not have been assigned to work the pre-filing selected issue in a post-filing examination due to other priorities. Their comments suggested that the workload for pre-filing agreements posed a competition for limited specialist resources.

To allocate examination specialist resources between pre-filing and post-filing activities so they will be most effective, objective criteria need to be developed.

When the Pre-filing Agreement Program becomes operational there will need to be criteria to allocate examination specialist resources to returns with the most significant issues between pre-filing and post-filing activities to ensure the most effective use of these resources.

Agreements were limited to one tax issue for one tax year

According to Notice 2000-12, a Pre-filing Agreement is a closing agreement between the IRS and taxpayer relating to one or more specific issues arising from transactions entered into by the taxpayer during a taxable period ending prior to the date of the agreement. IRS officials publicly stated that the project was limited to one tax issue for one tax period. Taxpayers involved in the pilot project recommended that agreements in a fully operational program cover more than one tax year. In fact, in a November 15, 2000 article in *Tax Notes Today*, Oracle Corporation’s Senior Vice President of Tax stated “…businesses would like their investment in the prefiling agreement process to lead to formal resolution of the same issue postaudit or for future years."

Multiple year agreements would benefit both taxpayers and the IRS.

A multiple year agreement would help offset the business taxpayers' investment in time, resources, and money associated with the Pre-filing Agreement process. The IRS would also benefit by settling tax issues for a set period of time, provided the taxpayers continued to comply with their agreements. This would free some of the LMSB Division's compliance resources for redeployment to other areas of concern.

The 11 taxpayers involved were part of the 1,700 taxpayers in the CEP that have an ongoing examination relationship with the IRS

The majority of tax issues accepted into the Pre-filing Agreement Pilot Project had previously been the subject of a post-filing examination. Consequently, the examination teams were experienced and familiar with both the taxpayer's books and records, and the tax issues. This enabled them to successfully develop the issue and reach an agreement in a short period of time.

Examination team members stated that an ongoing relationship with the taxpayer's employees and completed audit work on the tax issue from the prior cycles were crucial in reaching an agreement and meeting the initial 6-month time frame of the pilot. However, in an operational program the LMSB Division will face the challenge of executing an agreement before the tax return filing deadline for other taxpayers that are not examined on an annual basis with recurring tax issues like taxpayers in the CEP.

Cases were closely monitored and scrutinized by various levels of the LMSB Division management team

During the pilot project, issue development in the cases was closely monitored and reviewed by officials from the LMSB Division's Office of Pre-filing and Technical Guidance. When an agreement was made between the IRS and the taxpayer, the closing agreements were reviewed by the IRS' Office of Chief Counsel. The

LMSB Division Industry Director then reviewed and signed the closing agreement. This intense scrutiny eliminated the need for a systematic quality review system for the pilot project cases.

A method of quality review is needed to ensure the quality of issue development supporting Pre-filing Agreements.

The LMSB Division's *Business Performance Review*, dated December 1, 2000, projected 100 Pre-filing Agreements in FY 2001, and 200 in FY 2002. In an operational program with hundreds of cases it is possible that the authority to sign a closing agreement will be delegated to a management level lower than the Industry Director. Case reviews by Headquarters officials will be less frequent. Therefore, some method of quality review will be needed to ensure the quality of issue development supporting the Pre-filing Agreements.

An informal, flexible and effective management information system evolved to allow managers to direct and capture project accomplishments

During the pilot project a manual stand-alone monthly reporting system was established to monitor the status and results of the 11 cases with 12 issues. The system captured staff days of the individual team members, specific tax issue information, the case status, and closing agreement information.

This monthly reporting system, along with information from the Pre-filing application closing agreement and employee and taxpayer surveys, formed a comprehensive MIS to help manage the pilot. However, such a system will not easily scale up to meet the expected demands of 100 cases for FY 2001 and 200 cases in FY 2002. When the program becomes operational, an accurate and reliable MIS will be needed that allows managers to efficiently and effectively monitor the program. This MIS should also link to other LMSB Division information systems to facilitate management information needs.

The LMSB Division management team is taking action to address many of these challenges and is in the process of converting the pilot project into an operational program. For example, the LMSB Division management team is currently in the process of acquiring computer resources to help develop an MIS, and the LMSB Quality Measurement System has incorporated Pre-filing Agreements into its review of closed cases. During the pilot LMSB Division managers received feedback from employees and taxpayers concerning changes needed to make the pilot into an operational program. LMSB Division management's summary to the Pre-filing Agreement Pilot Project captured comments, observations, and recommendations describing potential changes needed to make the pilot project an operational program.

Recommendations

1. The Director, Strategy, Research and Program Planning, and the Director of Field Specialists should establish objective criteria to effectively allocate examination specialists to the returns with the most significant issues for pre-filing and post-filing activities.

   Management's Response: The LMSB Division, has significantly lowered its projections for the number of Pre-filing Agreements to 30 in FY 2002. As a result, the allocation of examination specialists is not a significant challenge. The current LMSB Compliance Workplan process can be used to set priorities and identify resource needs for the Pre-filing Program.

   Office of Audit Comment: We agree with the Commissioner, considering the impact of the anticipated sharp decline in the demand for pre-filing agreements. However, one of the primary benefits envisioned in establishing the Pre-filing Agreement Program was eliminating a significant and potentially contentious tax issue, thereby reducing the time taken in post-filing examinations. We believe the revised projection of only 30 pre-filing agreements a year raises concerns about whether there will be much, if any, reduction in the average length of post-filing examinations, considering the

Division examines approximately 20,000 returns a year.

2. The Commissioner, LMSB Division, should expand Pre-filing Agreements to cover multiple years as the LMSB Division's taxpayers are requesting.

   Management's Response: The Commissioner, LMSB Division, stated that multiple-year agreements are outside the Division's authority and decided to take no action on this recommendation.

   Office of Audit Comment: We agree with the technical accuracy of the Commissioner's comment. However, we believe the fact that multiple-year agreements are not offered could be a contributing factor to a lower than projected interest in the program. As such, the Commissioner, LMSB Division, could initiate actions to request the delegated authority from the IRS Commissioner. Implementing multiple-year agreements would be responsive to the taxpayers' stated needs and would demonstrate a change to a more customer-focused organization.

3. The Director of Pre-Filing and Technical Guidance, who is responsible for the overall direction of the Pre-filing Program, should monitor taxpayers who do not have an ongoing examination relationship with the IRS and adjust the program to meet the specific needs of this group.

   Management's response: The Commissioner, LMSB Division, stated the current program design and process will address the needs of all LMSB Division taxpayers and decided to take no action on this recommendation.

   Office of Audit Comment: We agree that with only 30 pre-filing agreements a year, the existing program design and process will likely provide the flexibility needed to meet the needs of taxpayers that do not have an ongoing relationship with the IRS.

4. The Director, Performance, Quality and Innovation, who is responsible for the assessments of operational effectiveness of both in-process and examined cases, should establish a method of systematic quality control for Pre-filing Agreements, similar in nature to the one for post-filing examinations, to maintain consistent case development standards.

   Management's Response: The Commissioner, LMSB Division, incorporated the quality review of Pre-filing Agreement examinations into the LMSB Quality Measurement System and decided to take no further action.

   Office of Audit Comment: We acknowledge that the LMSB Quality Measurement System could be used as a quality control, given the anticipated reduced demand for pre-filing agreements.

5. The Director, Business Systems Planning, who is responsible for managing all major change projects, should develop an MIS to support the Pre-filing Agreement Program, that is integrated with the other LMSB Division information systems on-line or under development, which will direct and control the program and capture results.

   Management's Response: The Commissioner, LMSB Division, agreed with this recommendation. Initially, external consultants planned to develop a stand-alone pre-filing MIS beginning in July 2001 that will be operational during FY 2002. This system will be incorporated into the LMSB Division's MIS during the fourth quarter of FY 2003.

Conclusion

The Pre-filing Agreement Pilot Project was successful, but challenges remain in moving from a pilot project to an effective and efficient operational program. These challenges present the LMSB Division with an opportunity to enhance the effectiveness and efficiency of the Pre-filing Program in ways that could increase taxpayer satisfaction, and reduce costs and burdens to both taxpayers and the IRS.

Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to determine whether the Pre-filing Agreement Pilot Project was effectively designed and implemented to provide officials with reliable information for deciding whether it should be expanded, modified, or terminated. On-site tests were conducted in the Internal Revenue Service's (IRS) Large and Mid-Size Business (LMSB) Division's National Headquarters and at IRS offices in Fayetteville, Arkansas; Independence, Ohio; Redwood City, California; and San Francisco, California. The specific audit tests included the following.

I. Determined whether an effective process was developed and followed for implementing the Pre-filing Agreement Pilot Program.

A. Reviewed the Phase II Design Team Process Deck that outlined the Pre-filing Agreement methodology, and the goals, objectives, performance measures, and scope of the pilot project.

B. Analyzed the sufficiency of any assessment conducted of the risks associated with the agreement process.

C. Interviewed management officials from the IRS' LMSB Division Pre-filing Agreement Design Team, the Office of Pre-filing and Technical Guidance, the Taxpayer Advocate Service, the Office of Appeals, and the Office of Chief Counsel concerning development and implementation of the Pre-filing Agreement Pilot Program.

D. Reviewed the training materials used to educate first line managers and employees about the Pre-filing Initiative.

E. Reviewed and analyzed information concerning issue codes similar to those in the pilot project and their related amounts from the Coordinated Examination Management Information System for Fiscal Years (FY) 1998 to 1999.

F. Reviewed and analyzed information concerning issue codes similar to those in the pilot project and their related amounts from the Combined Enhanced Nationwide Tracking and Uniform Reporting System for FY 1999.

G. Reviewed the 19 application packages to verify timeliness of actions and to determine whether there were any biases in the selection process. Reviewed the 12 applications selected into the program to ascertain whether they were geographically dispersed. Reviewed the 7 rejected applications to determine whether the criteria outlined in Notice 2000-12 supported the rejection.

II. Determined whether the LMSB Division developed an effective process to measure results of the pilot that established a definitive determination of program effectiveness.

A. Reviewed the post closing agreement surveys from taxpayers submitted to the Pre-filing Agreement Pilot Project Manager to assess customer satisfaction and suggested improvements.

B. Reviewed the post closing agreement surveys from employees submitted to the Pre-filing Agreement Pilot Project Manager to assess employee satisfaction and suggested improvements.

C. Conducted field visitations on 5 of the 12 accepted applications, judgmentally selected based on geographical dispersion. Reviewed workpapers to determine how long the pre-filing agreement issue was under examination, the team members conducting the examination, the amount of time applied, and whether the examination met the appropriate auditing standards for issue development and tax law application.

D. Reviewed and analyzed information from the Audit Information Management System for FY 2000. Reviewed Table 37, Examination Program Monitoring FY 2000, for Direct Examination Staff Years by position and program accomplishments in the Coordinated Examination Program (CEP) and Non-CEP programs.

E. Reviewed the pilot project report results on staff days expended and elapsed time captured on the examinations of the pre-filing applicants.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Management's Response to the Draft Report

COMMISSIONER
LARGE AND MID-SIZE
BUSINESS DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Larry Langdon
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report 2000-30-031, The Pre-filing Agreement Pilot Project Was Successful, But Faces Challenges in Converting to an Operational Program

Thank you for the opportunity to review and comment on the subject draft report, and for the time your staff spent with us reviewing the Pre-Filing Agreements Discussion Draft Report.

We agree with your conclusion that the Pre-filing Agreement (PFA) Pilot was effectively designed and executed to provide officials with reliable information. We carefully considered the recommendations and significant challenges identified in your draft report and offer the following comments:

IDENTITY OF RECOMMENDATION/FINDING #1:

Recommendation

The Director, Strategy, Research and Program Planning, and the Director, Field Specialists should establish objective criteria to effectively allocate examination specialists to the returns with the most significant issues for pre-filing and post-filing activities.

Significant Challenge

Pilot cases were given priority access to scarce examination specialist resources. When the Pre-filing initiative becomes fully operational, this same level of priority access may not be possible, potentially hindering the program's ability to meet its goals and milestones.

ASSESSMENT OF CAUSE(S):

We do not believe this represents a significant challenge. The Office of Pre-Filing and Technical Guidance expects to accept about 30 PFA applications in FY 2002. Based on further assessment of the potential demand, the estimated acceptance rate for FY 2002 was revised from 100 to 30 cases. Using this projection and applying the report methodology, we would have about one staff year of specialist time committed to PFA activities; an amount well within available resources. Moreover, we are committed to providing the necessary resources to effectively deliver the PFA Program.

The Office of Strategy, Research and Program Planning in LMSB is responsible for developing the LMSB Compliance Workplan. One of the objectives of the workplan is to prioritize and identify resource needs and allocate those resources to support the LMSB strategic initiatives and program emphasis areas. We are using this process, so no further actions are required. We will manage the staffing for PFA activities under the current processes.

CORRECTIVE ACTION: No corrective action is necessary.

IMPLEMENTATION DATE: Not applicable

RESPONSIBLE OFFICIAL: Not Applicable

IDENTITY OF RECOMMENDATION/FINDING #2:

Recommendation:

The Commissioner, LMSB Division, should expand Pre-filing Agreements to cover multiple years as the LMSB Division's taxpayers are requesting.

Significant Challenge:

Agreements were limited to one tax issue for one tax year. Taxpayers involved in the pilot project recommended that agreements in a fully operational program cover more than one tax year.

ASSESSMENT OF CAUSE(S):

We do not have the authority to enter into closing agreements on prospective transactions. Generally, we do not have the authority to enter into any agreement on a taxable period beyond that anticipated by the PFA Program and the Revenue Procedure. Accordingly, a prospective multiple year agreement is not within the authority of the LMSB.

The Treasury Secretary has authority to enter an agreement in writing with any person on their tax liability for any taxable period [I.R.C. Section 7121]. Regulations under this section, and Treasury Orders, delegate that authority to the IRS Commissioner. The Commissioner may enter into agreements on taxable periods that ended before the date of the agreement for either the total tax liability of the taxpayer or one or more items affecting that tax liability [Treasury Regulation 301.7121-1(b)(2)]. Closing agreements for taxable periods ending after the date of the agreement may relate only to one or more items affecting the tax liability of the taxpayer [Treasury Regulation 301.7121-1(b)(3)].

The Commissioner's authority to enter closing agreements for tax periods ended before the date of the agreement is widely delegated. Authority to enter into agreements on prospective transactions or completed transactions before affected returns are filed is generally limited to the Chief Counsel [Delegation Order Number 97]. We must have a specific delegation to authorize LMSB officials to enter into closing agreements on a taxpayer's liability for a period ended after the date of the agreement to cover the agreements anticipated by the PFA Program [Delegation Order Number 262 Revision 1]. The authority only extends to agreements described in Revenue Procedure 2001-22, 2001-9 I.R.B. 745.

CORRECTIVE ACTION: No corrective action is necessary.

IMPLEMENTATION DATE: Not applicable.

RESPONSIBLE OFFICIAL: Not applicable

IDENTITY OF RECOMMENDATION/FINDING #3:

Recommendation:

The Director, Office of Pre-Filing and Technical Guidance, who is responsible for the overall direction of the Pre-filing Program, should monitor taxpayers who do not have an ongoing examination relationship with the IRS and adjust the program to meet the specific needs of this group.

Significant Challenge:

The 11 taxpayers involved in the pilot were part of the 1,700 taxpayers in the Coordinated Examination Program (CEP) that have an ongoing examination relationship with the IRS. In an operational program, the LMSB Division will be faced with the challenge to execute an agreement before the tax return filing deadline for the other taxpayers that are not examined on an annual basis with recurring tax issues like taxpayers in the CEP.

ASSESSMENT OF CAUSE(S):

The operational PFA program includes all taxpayers under the jurisdiction of the LMSB Division, whether Coordinated Industry Cases or Industry Cases. Similar to the Pilot, we will closely monitor all taxpayers accepted in the PFA Program throughout the process. Additionally, the Tier II PFA screening process requires the LMSB Industry office to consider the availability of resources and the probability of success in accepting a taxpayer's PFA request into the program.

A formal taxpayer's request and application initiate the PFA process. The LMSB Division has implemented a process to communicate and market the availability and benefits of the PFA process to all LMSB taxpayers. Because the process is voluntary, LMSB should not conduct monitoring activities of taxpayers that do not have an on-going examination relationship with the IRS. Accordingly, we believe the current program design and process addresses the needs of all LMSB taxpayers.

CORRECTIVE ACTION: No corrective action is necessary.

IMPLEMENTATION DATE: Not applicable.

RESPONSIBLE OFFICIAL: Not applicable.

IDENTITY OF RECOMMENDATION/FINDING #4:

Recommendation:

The Director, Performance, Quality and Innovation, who is responsible for the assessments of operational effectiveness of both in-process and examined cases, should establish a method of systematic quality control for Pre-filing Agreements, similar in nature to the one for post-filing examinations, to maintain consistent case development standards.

Significant Challenge:

During the pilot project, issue development in the cases was closely monitored and reviewed by officials from the LMSB Division's Office of Pre-filing and Technical Guidance. When an agreement was made between the IRS and the taxpayer, the closing agreements were reviewed by the IRS' Office of Chief Counsel. The LMSB Division Industry Director then reviewed and executed the closing agreement. This intense scrutiny eliminated the need for a systematic quality review system for the pilot project cases. Case reviews by Headquarters officials will be more infrequent. Therefore, some method of quality review will be needed to ensure the quality of issue development supporting the Pre-filing Agreements.

ASSESSMENT OF CAUSE(S):

The Office of Pre-filing and Technical Guidance projects the number of Pre-filing Agreements that may be approved annually. Based on current demand, we expect to approve about 30 cases for the next fiscal year. For the operational program, we adopted the same processes we used in the pilot to evaluate the applications and review the closing agreements. We also used the same level of scrutiny. Chief Counsel and the LMSB Technical Advisors will review the closing agreements (as appropriate). The LMSB Industry Director will continue to review and execute the closing agreements. The Office of Pre-filing and Technical Guidance will continue to provide overall coordination of the process.

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We put an LMSB Quality Measurement System (LQMS) in place to measure the quality of examinations for both Industry and Coordinated Industry cases. We will determine a statistically valid sample of Coordinated Industry cases for three milestones:

1. At 25 percent of applied time
2. At 50 percent of applied time
3. At case completion

Presently, we are conducting reviews at the 50 percent and case completion milestones. Additionally, we will review a statistically valid sample of completed Industry cases.

The LMSB Office of Performance Management, Quality Assurance, and Innovation (PQI) will review cases that may include pre-filing agreements. Their review will assess whether the taxpayer complied with the conditions of the PFA. The PQI Office would review a PFA if it selects, as part of the statistically valid sample, a case that has a pre-filing closing agreement. We anticipate the PQI Office will review 50-75 percent of all PFA cases using our sampling process. We do not believe we should establish a new quality review process for the remaining 25-50 percent of PFAs not identified in the sample. Accordingly, we believe the current PFA process and Quality Review process is sufficient to ensure systematic quality control.

CORRECTIVE ACTION: No corrective action is necessary.

IMPLEMENTATION DATE: Not applicable.

RESPONSIBLE OFFICIAL: Not Applicable

IDENTITY OF RECOMMENDATION/FINDING #5:

Recommendation:

The Director, Business Systems Planning, who is responsible for managing all major change projects, should develop an MIS to support the Pre-filing Agreement Program, that is integrated with the other LMSB Division information systems on-line or under development, which will direct and control the program and capture results.

Significant Challenge:

An informal, flexible and effective management information system evolved to allow managers to direct and capture project accomplishments. During the pilot project, a manual stand-alone monthly reporting system was established to monitor the status and results of the 11 cases with 12 issues. However, such a system will not easily scale up to meet the expected demands of 100 cases for FY 2001 and 200 cases in FY 2002.

ASSESSMENT OF CAUSE(S):

We agree we need to develop an effective and flexible Management Information System (MIS) to monitor and capture PFA Program accomplishments. Even though we revised our initial projections of 100 cases for FY 2001 and 200 cases in FY 2002 to reflect about 30 cases annually, we recognize the need to develop an MIS.

We must incorporate the PFA MIS Project requirements into our Tier-B information system project planning for FY 2003. We will have to budget the cost for the LMSB MIS projects through the Tier-B Information Systems process. We will need reliable and accurate information to effectively control and monitor the results.

CORRECTIVE ACTIONS:

External MIS consultants will start developing a PFA MIS in July 2001. We intend to evaluate and enhance the Pilot MIS to address any deficiencies and to provide enhancements where appropriate. Initially, we will establish a stand-alone MIS, monitor the use of that system for a period, and integrate the PFA MIS into the larger LMSB Division-wide management information system.

We will gather the requirements from the PFA Project and incorporate the requirements into the LMSB Information Technology Plan for FY 2003 Tier-B projects. We expect to begin development in FY 2003. Based on design and planning, we should incorporate the requirements into the LMSB MIS system in the fourth quarter of FY 2003.

IMPLEMENTATION DATE:

PROPOSED: December 31, 2003

RESPONSIBLE OFFICIAL:

Director, Business Systems Planning

CORRECTIVE ACTIONS MONITORING PLAN:

We estimate we will complete the stand-alone management information system during FY 2001 and put into operation in FY 2002. In FY 2003, we expect to develop the project requirements to migrate the PFA MIS into the LMSB-wide MIS.

If you have any questions, please contact Gerald Reese, Director, Pre-filing and Technical Guidance, at (202) 283-8461.